

STATE RETIREMENT AND PENSION SYSTEM OF MARYLAND



COMPREHENSIVE ANNUAL FINANCIAL REPORT

A PENSION TRUST FUND OF THE STATE OF MARYLAND

FOR THE YEAR ENDED JUNE 30, 2004

Prepared by:

State Retirement Agency of Maryland
120 East Baltimore Street
Baltimore, Maryland 21202

INTRODUCTORY SECTION:

Letter of Transmittal	4
Message from the Board	7
Board of Trustees	8
Public Advisors to the Investment Committee	9
Organizational Chart	10
Professional Services	11
Certificate of Achievement	12

FINANCIAL SECTION:

Independent Auditor's Report	14
Management's Discussion and Analysis	15
Financial Statements:	
Statements of Plan Net Assets	22
Statements of Changes in Plan Net Assets	23
Notes to the Financial Statements	24
Required Supplementary Information:	
Schedule of Funding Progress	32
Schedule of Contributions from Employers and Other Contributing Entity	32
Notes to the Required Supplementary Information	33
Other Supplementary Information:	
Schedule of Fund Balances	35
Schedule of Administrative Expenses	36
Schedule of Investment Expenses	36
Transfer Refund Rate	37
Schedule of Plan Net Assets by System	38
Schedule of Changes in Plan Net Assets by System	40

INVESTMENT SECTION:

Chief Investment Officer's Report	44
Investment Portfolios by Manager	49
Investment Portfolio Summary	49
Investment Portfolio Allocation	50
Fixed Income Distribution by Type	50
Equity Distribution by Type	51
Real Estate Distribution by Type	51
Comparative Investment Returns:	
Domestic Equity	52
International Equity	52
Real Estate Investment Trust	53
Fixed Income	53
Ten-Year History of Time-Weighted Annual Returns	54
Ten-Year Growth of Investment Portfolio	54
Largest 25 Holdings	55
Domestic and International Equity Commissions to Brokers	56

ACTUARIAL SECTION:

Independent Actuary's Certification Letter	58
Board Summary	59
Actuarial Methods and Assumptions	62
Accounting Statement Information	63
Summary of Unfunded Actuarial Liabilities/Solvency Test	64
Summary of Retirees and Beneficiaries Added to and Removed from Rolls	64
Statement of Changes in Total Actuarial Present Value of All Accrued Benefits	65
Summaries of Principal Results	66
Schedule of Active Membership Valuation Data by Plan	73

STATISTICAL SECTION:

Schedule of Retired Members by Type of Retirement and Option Selected	78
Schedule of Benefit Expense by Type	78
Summary of Membership Data by Plan	80
Ten-Year History of Membership by Plan	82
Total System Membership	82
Membership in Teachers' Plans	82
Membership in Employees' Plans	82
Ten-Year History of Retirees and Beneficiaries by Plan	83
Total System Retirees and Beneficiaries	83
Ten-Year History of Changes in Fund Balance	84
Ten-Year History of Employer Contribution Rates by Plan	84
Ten-Year History of Revenues by Source and Expenses by Type	85
Employer Contributions Received	86
Ten-Year History of Funding Progress	87
Ten-Year History of Revenues vs. Expenses	87
Governmental Units Participating in the Systems.....	88
Withdrawn Governmental Units	88

PLAN SUMMARY SECTION:

Teachers' Retirement System	90
Teachers' Pension System	92
Employees' Retirement System	94
Employees' Pension System	96
Judges' Retirement System	98
State Police Retirement System	100
Law Enforcement Officers' Pension System	102
Local Fire and Police System	104



STATE RETIREMENT
and PENSION SYSTEM
of MARYLAND

STATE RETIREMENT AGENCY
120 East Baltimore Street
Baltimore, MD 21202
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www.sra.state.md.us

Thomas K. Lee
*Executive Director
secretary To The Board
Board Of Trustees*

LETTER OF TRANSMITTAL

December 15, 2004

Honorable Chairman & Members of the Board of Trustees:

We are pleased to submit the Comprehensive Annual Financial Report for the State Retirement and Pension System of Maryland (the "System") for the fiscal year ended June 30, 2004. We believe this report fairly reflects the results achieved during 2004.

The System is charged with the fiduciary responsibility for properly administering the retirement and pension allowances and other benefits, while striving to keep employer contribution rates as affordable as possible while maximizing investment returns and maintaining an acceptable level of risk. Members covered by the plans include State employees, teachers, law enforcement officers, legislators, judges, as well as local government employees and fire fighters whose employers have elected to participate in the System.

Seventy-seven years ago, the first statewide retirement plan in Maryland (the Teachers' Retirement System) was established. Fourteen years later, in 1941, the Employees' Retirement System was established. Together these two plans comprise the majority of the System's membership. The System now provides monthly allowances to more than 94,000 retirees and beneficiaries, and is an essential element of the future financial security for over 185,000 active participating members. Descriptions of the membership requirements of, and benefits provided by, each plan administered by the System are included in the Plan Summary Section starting on page 90.

This Comprehensive Annual Financial Report contains six sections. The Introductory Section includes this letter of transmittal, along with information about the administrative structure of the System. The Financial, Actuarial and Investment Sections provide a comprehensive review of the System's financial position, the results of its operations and its funded status. Viewed separately, each of these three sections provides information about a different aspect of the System's long-standing record of stewardship and financial stability. In this regard, the Financial Section contains the report from the System's independent auditor, the combined financial statements and supplementary financial data. The Actuarial Section contains the independent actuary's certification, as well as the results of the System's annual actuarial valuation. The Investment Section includes a report from the System's Chief Investment Officer highlighting the past year's performance in addition to various summary level portfolio composition and performance data. The Plan Summary and Statistical Sections provide detailed descriptions of the various plans' provisions and the demographic composition of the membership segments affected by each plan.

In addition to this Letter of Transmittal, additional narrative, overview and analysis can be found in Management's Discussion and Analysis found on pages 15 through 20 of this annual report.

Economic Environment

In contrast to fiscal years 2001 and 2002, the fund continued the strong investment gains experienced in the latter part of fiscal year 2003 with an exceptional return of 16.2% during fiscal year 2004. This investment return more than doubled the System's actuarially determined target investment return of 7.75%. The actuarially determined target investment return

of 7.75% is a long-term target and, as such, significant deviations from this target can be expected, both positive and negative, from year to year. Because returns are smoothed over a 5 year period for actuarial valuation purposes, the fund still experienced a decrease in its funded ratio from 93.30% to 92.18%. Despite this temporary downturn, the System remains financially strong and ahead of schedule with regard to its long-term funding goals.

Investment Strategies

Under the experienced direction of its Board of Trustees, the System plans to continue following its steady course toward maximizing investment returns while maintaining an acceptable level of risk. In the months ahead, the System will continue to deploy assets at home as well as throughout the expanding global markets in an effort to maintain an appropriate portfolio balance.

Major Issues and Initiatives

This past year has been one of assessment, evaluation and implementation for the Agency, focusing on the key areas of governance, infrastructure, and investment administration. Over the next decade, the Agency will be faced with meeting the needs of an increasing number of participants as the “baby boomer” generation reaches retirement age.

During the past year, the Board’s focus has been on governance. As a part of this focus, an extensive fiduciary audit was conducted, which resulted in the adoption of an enhanced governance policy articulating strong standards and guidelines for accountability. The changes being implemented represent best practices in governance reengineering strategies. In addition, the Board’s structure now reflects recent legislation that strengthened and broadened the Board of Trustees by requiring that four trustees have substantial experience overseeing similar pension systems, large foundations, or other similar large organizations with fiduciary responsibilities relating to different classes of participants.

The Agency has contracted for, and is currently undergoing, a business process review covering the administration of benefits and related financial components. The review is a comprehensive analysis of the “as is” process, actively seeking areas to assist the Agency in more effectively meeting its goals. The results of the evaluation will be the foundation for the development of the information system scheduled to replace the current legacy system.

For the past year, the Agency has been working to structure the most appropriate and fiscally sound investment program for the current and future retirees of Maryland and the associated systems. Our asset classes and respective

allocations to stocks, bonds, and real estate have been restructured to achieve the highest return based on prudent investment principles. In accordance with our responsibility for due diligence and the increasing complexities in investment markets, we are in the process of building a strong monitoring and risk management process to ensure more effective oversight of investment managers, and to protect and grow plan surplus.

Financial Information

Because System management is responsible for the information contained in this report, we have committed the resources necessary to maintain an internal control structure which provides reasonable assurance that assets are adequately safeguarded and the financial records are consistently and accurately maintained. Accordingly, we are confident that the financial statements, supporting schedules and statistical tables included in this report fairly present the System’s financial condition and the results of its operations in all material respects.

Accounting System and Reports

The System reports its transactions on the accrual basis of accounting, under which revenues are reported in the accounting period in which they are earned and become measurable and expenses are reported when the related liability is incurred. Investments are reported at fair value at fiscal year end. Investment purchases and sales are reported in the accounting period in which the related trade dates occur.

Revenues

The reserves necessary to finance retirement allowances and other benefits are accumulated through investment earnings and the collection of employer and member contributions. During fiscal year 2004, investment earnings were \$4.2 billion, while revenues from employer and member contributions were \$627 million and \$204 million, respectively. For fiscal year 2004, member contribution rates remained unchanged, while employer rates varied depending on the System.

Expenses

The System’s expenses consist of monthly retirement allowances, refunds of contributions to terminated and transferring members and withdrawing employers, and the administrative cost of System operations. As expected, payments to retirees, beneficiaries and transferring or withdrawing members and employers continued to be the System’s primary disbursements during 2004, totaling \$1,582.5 million. Of this amount, the System disbursed

\$1,570.6 million as retirement allowances to members and beneficiaries. The remaining \$11.9 million was paid to members and withdrawing employers as a result of employment terminations, system transfers or withdrawal. Administrative and investment expenses are entirely funded through investment income. Of the \$86 million disbursed during fiscal year 2004 to manage the investment portfolio and to administer the System, \$69 million was paid for investment management, portfolio custody and securities lending services while \$17 million was used to fund the System's administrative operations.

Funding and Reserves

Funds, derived from the excess of revenues over expenses, are accumulated by the System in order to meet benefit obligations to both current and future retirees and beneficiaries. The Annotated Code of Maryland requires participating employers to make periodic contributions which, as a level percentage of payroll, will fund the employers' "normal costs" over the members' average active service period, and the System's accrued unfunded liability in separate annual layers. Specifically, the unfunded actuarial liability that existed at June 30, 2000 will continue to be amortized over the remaining 16-year period to June 30, 2020, whereas each subsequent annual liability layer will be amortized over a 25-year period. Each year the Board of Trustees certifies the required employer contribution rates based on the actuary's annual valuation and recommendations.

At June 30, 2004, the System's actuarial accrued liability was \$36.3 billion. With the actuarial value of assets accumulated to pay the liability at \$33.5 billion, the System now stands at 92.18 percent funded.

Investments

We are pleased the System delivered above-median returns for fiscal year 2004 for plan participants and beneficiaries. Going forward for fiscal year 2005, the Agency will continue to search for the optimal tradeoff that will provide an attractive return expectation while maintaining acceptable levels of risk. Furthermore, the Agency maintains that the integrity of the capital markets directly affects the System and all of its participants and stakeholders. Through the newly established Corporate Governance Subcommittee, the Agency's focus will be on stewardship and the concomitant responsibility of holding the companies with which we invest accountable for actions that impact those assets.

Professional Services

The System contracts for the services of various independent consulting, investment advisory and financial professionals to assist the Board of Trustees in carrying out its

fiduciary responsibility to efficiently and effectively manage the System. For example, actuarial services were provided by Milliman USA and independent financial statement audit services were provided by the State of Maryland's Office of Legislative Audits. The System's asset custody and portfolio accounting services are provided by the State Street Bank & Trust Company under a multi-year, master custody arrangement. A complete listing of the System's professional consultants and external investment advisors is presented on page 11.

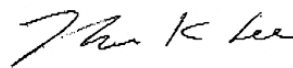
Certificate of Achievement for Excellence in Financial Reporting

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State Retirement and Pension System of Maryland for its comprehensive annual financial report for the fiscal year ended June 30, 2003. This was the fifteenth consecutive year (1989 through 2003) the State Retirement and Pension System of Maryland has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

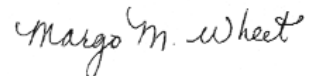
A Certificate of Achievement is valid for a period of one year only. We believe our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

Acknowledgments

This annual report reflects the dedicated efforts of the System's staff under the steady direction of the Board of Trustees. We extend our sincere gratitude to each member of the Board of Trustees, the Agency's staff, the Board's advisors and the many people who worked so hard to make fiscal year 2004 a success.



Thomas K. Lee
*Executive Director &
Secretary to the Board*



Margo M. Wheet, CPA
Chief Financial Officer



STATE RETIREMENT
and PENSION SYSTEM
of MARYLAND

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Thomas K. Lee
*Executive Director
secretary To The Board
Board Of Trustees*

December 15, 2004

Dear Members and Beneficiaries::

A positive investment environment continued in the financial markets for fiscal year ending June 30, 2004. Total investment return of the Maryland Retirement and Pension System (SRPS) was 16.2% compared with 3.2% for fiscal 2003. Total fund assets increased from \$26.7 billion in 2003 to \$30.1 billion at the close of fiscal 2004, for a gain of \$3.4 billion.

We are pleased also to report that for the period the SRPS portfolio ranking, as determined by the Trust Universal Comparison Report (TUCS), improved from the 75th percentile to 46th percentile reflecting the Agency's strong performance relative to its peers across the county.

The Board has worked diligently to achieve investment performance through the implementation of a structured, yet flexible strategic policy. This will continue to be a team effort with the Board, professional staff and consultants all having key roles in the process.

The Agency's annual allocation study, currently underway, will redefine the proportion of stocks, bonds, private equity and real estate to be held in the portfolio for the purpose of better managing risk and volatility. Long term analysis shows that 90 percent of the investment return results from having the proper asset allocation mix in place.

During the fiscal year, we welcomed the addition to the Board of Trustees of John W. Douglass and Sheila Hill elected by state employees, and gubernatorial appointments, F. Patrick Hughes and James M. Harkins. Art Caple, who served as a Trustee with loyalty and professionalism for 20 years, passed away on May 22, 2004. He will be greatly missed.

Your support and participation are greatly appreciated.

Sincerely,

WILLIAM DONALD SCHAEFER
Chairman

NANCY K. KOPP
Vice Chairman

BOARD OF TRUSTEES



WILLIAM DONALD SCHAEFER, *Chairman*
State Comptroller

Ex Officio since January 25, 1999
Member, Investment Committee



NANCY K. KOPP, *Vice Chairman*
State Treasurer

Ex Officio since February 14, 2002
Chairman, Real Estate Subcommittee
Vice Chairman, Investment Committee
Member, Administrative Committee
Member, Audit Committee
Member, Corporate Governance Subcommittee



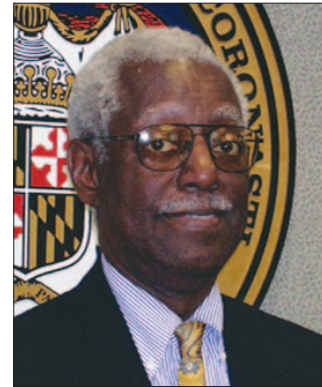
WILLIAM D. BROWN

August 1, 1997 – July 31, 2005
Chairman, Administrative Committee



JAMES C. DI PAULA, JR.

Ex Officio since January 15, 2003
Member, Investment Committee



JOHN W. DOUGLASS

May 18, 2004 – July 31, 2007
Member, Administrative Committee
Member, Audit Committee
Member, Corporate Governance Subcommittee



DAVID B. HAMILTON

July 1, 2003 - June 30, 2007
Chairman, Audit Committee
Member, Administrative Committee



JAMES M. HARKINS

October 1, 2004 - June 30, 2006
Member, Administrative Committee



F. PATRICK HUGHES

July 1, 2003 - June 30, 2005
Member, Audit Committee
Member, Investment Committee
Member, Real Estate Subcommittee

BOARD OF TRUSTEES



MAJOR MORRIS L. KROME

August 1, 1998 – July 31, 2006
Vice Chairman, Administrative Committee
Member, Audit Committee
Member, Investment Committee



CARL D. LANCASTER

August 1, 1987 – July 31, 2007
Chairman, Investment Committee
Member, Corporate Governance Subcommittee
Member, Real Estate Subcommittee



A. MELISSA MOYE, PH.D.

July 1, 2003 - June 30, 2007
Chairman, Corporate Governance Subcommittee
Member, Investment Committee
Member, Real Estate Subcommittee



SHEILA HILL

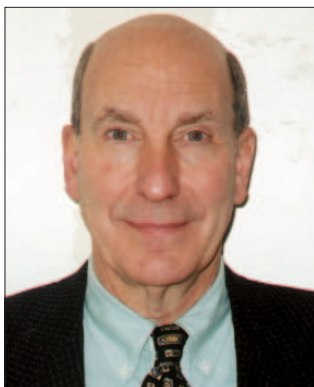
October 19, 2004 – July 31, 2005
Member, Administrative Committee
Member, Investment Committee



PATRICK A. O'SHEA

July 1, 2003 - June 30, 2007
Member, Investment Committee
Member, Real Estate Subcommittee

ADVISORS TO THE INVESTMENT COMMITTEE



ROBERT W. SCHAEFER



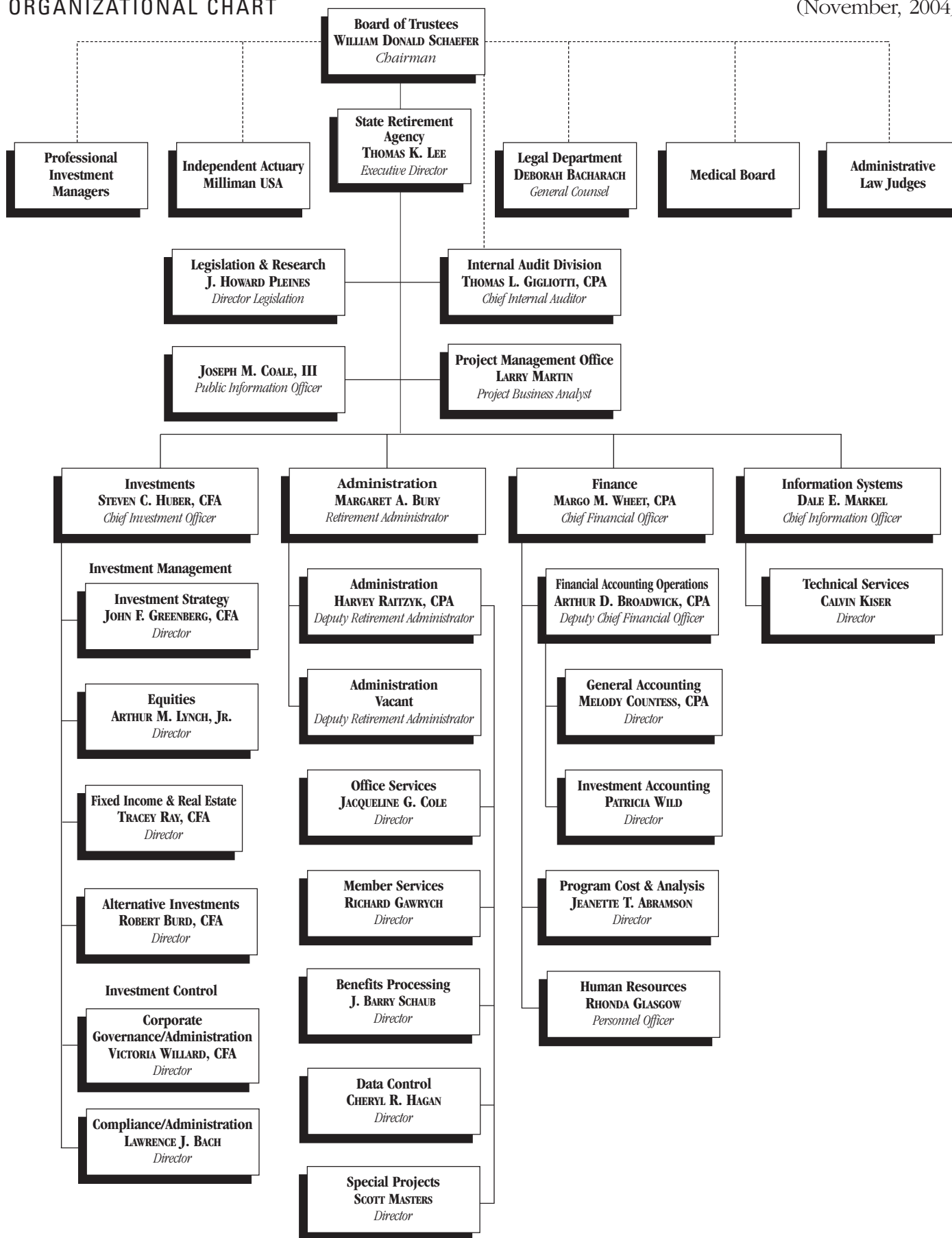
WAYNE H. SHANER



BRIAN B. TOPPING

ORGANIZATIONAL CHART

(November, 2004)



PROFESSIONAL SERVICES

ASSET & INCOME VERIFICATION SERVICES

Financial Control Systems, Inc.
Chadds Ford, Pennsylvania

EQUITY INVESTMENT MANAGERS

Abbott Capital Management, LLC
Boston, Massachusetts

Adams Street Partners, LLC
Chicago, Illinois

Advent Capital Management
New York, New York

Ariel Capital Management, Inc.
Chicago, Illinois

Artisan Partners Limited Partnership
San Francisco, California

Bank of Ireland Asset Management Limited
Dublin, Ireland

Brown Capital Management, Inc.
Baltimore, Maryland

Brown Investment Advisory &
Trust Company
Baltimore, Maryland

Capital Guardian Trust Company
Washington, D.C.

Dimensional Fund Advisors, Inc.
Santa Monica, California

The Edgar Lomax Company
Springfield, Virginia

HarbourVest Partners, LLC
Boston, Massachusetts

Legg Mason Capital Management, Inc.
Baltimore, Maryland

Maryland Venture Capital Trust
Baltimore, Maryland

Relational Investors, LLC
San Diego, California

Robert W. Torray & Co., Inc.
Bethesda, Maryland

State Street Global Advisors
Boston, Massachusetts

T. Rowe Price Associates, Inc.
Baltimore, Maryland

Templeton Investment Counsel, Inc.
Fort Lauderdale, Florida

Trust Company of the West (TCW)
Los Angeles, California

Wellington Management Co. LLP
Boston, Massachusetts

FIXED INCOME INVESTMENT MANAGERS

Bridgewater Associates, Inc.
Westport, Connecticut

Fountain Capital Management, LLC
Overland Park, Kansas

Pacific Investment Management Company
Newport Beach, California

Payden & Rygel
Los Angeles, California

State Street Global Advisors
Boston, Massachusetts

W.R. Huff Asset Management Co., LLC
Morristown, New Jersey

Western Asset Management
Pasadena, California

GLOBAL CUSTODIAL BANK & SECURITY LENDING

State Street Bank and Trust Company
Boston, Massachusetts

HEARING OFFICERS

Office of Administrative Hearings
Baltimore, Maryland

INDEPENDENT ACTUARY

Milliman USA
Baltimore, Maryland

INDEPENDENT AUDITOR

Office of Legislative Audits
Baltimore, Maryland

INDEPENDENT INVESTMENT CONSULTANT

Ennis Knupp & Associates
Chicago, Illinois

MEDICAL BOARD

John J. Fahey, M.D.
Norman Freeman, Jr. M.D.
Arthur Hildreth, M.D.
Bruce Z. Kohn, M.D.
William B. Russell, M.D.
Alfred Wiedmann, M.D.

OPERATIONAL BANKING SERVICES

M & T Bank
Baltimore, Maryland

The Harbor Bank of Maryland
Baltimore, Maryland

PRIVATE EQUITY CONSULTANT

Altius Associates Limited
Richmond, Virginia

REAL ESTATE INVESTMENT MANAGERS

Chesapeake Maryland Limited Partnership
Baltimore, Maryland

J.P. Morgan Investment Management, Inc.
New York, New York

LaSalle Investment Management, Inc.
Baltimore, Maryland

LaSalle Investment Management
Securities, LP
Baltimore, Maryland

Lubert-Adler Management, Inc.
Philadelphia, Pennsylvania

Prudential Investment/CIGNA
Parsippany, New Jersey

Certificate of Achievement for Excellence in Financial Reporting

Presented to

State Retirement and Pension System of Maryland

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2003

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director